THE JOURNAL

OF

POLITICAL ECONOMY

VOLUME 29 — *June 1921* — NUMBER 6

THE FEDERAL FARM LOAN CASE

Without a dissenting vote upon the main issue, the Supreme Court has recently held the Federal Farm Loan Act constitutional. This decision, announced February 28, 1921, adds another to the line of decisions upholding the right of Congress to create federal banking institutions. On the strength of this decision, the federal and joint-stock land banks have resumed loaning operations after a year of comparative inactivity. The system appears now to be a permanent part of our financial organization. The task of the future is to perfect and develop it. This paper undertakes to make an analysis of the issues in the recent case and to discuss certain policies of the banks with a view to suggesting amendments to the Act to meet legitimate objections raised against the law and its administration.

THE PURPOSES AND ORGANIZATION PLAN OF THE FEDERAL FARM LOAN SYSTEM

The Federal Farm Loan Act was approved July 17, 1916, and the banks were established in March, 1917. The purposes of the Act were to provide capital for agricultural development at lower rates and for longer terms than could be secured from existing loaning agencies; to equalize rates of interest upon farm loans; to create standard forms of bonds based upon farm mortgages, and incidentally to furnish a market for government bonds; and to

create government depositories and financial agents for the United States.

At the head of the system thus established was a Federal Farm Loan Bureau, located in the Department of the Treasury. This Bureau was placed under the supervision of the Federal Farm Loan Board, a body consisting of five members to be appointed by the President, including the Secretary of the Treasury ex officio. Loans can be made by the twelve federal land banks only to bona fide farmers upon first mortgage security. With negligible exceptions, the loans are made through national farm loan associations, the co-operative local associations of borrowing farmers.

In addition to the capital stock of the banks, funds for making loans are secured by the sale of bonds issued by the banks. These bonds are secured by the farm mortgages held under the control of the Farm Loan Board. They are further secured by the assets of all of the twelve federal land banks. Because of the careful supervision of the issue of these bonds and their excellent security, it was expected that they would find a very wide market, thus creating a "standard form of investment."

In addition to the provision for the federal land banks, Congress also included in the act provision for corporations known as joint-stock land banks. These are private mortgage banks which operate independently of the federal land banks but under the supervision of the Farm Loan Board. In exercising its powers of supervision, the Farm Loan Board has ruled that the purposes for which loans may be made must conform to the general purpose of agricultural development, though they may loan to others than actual farmers.[1] Joint-stock land banks also issue bonds upon the same terms as the federal land banks. There is no mutual guaranty for these bonds, and they are entirely independent of those issued by the federal land banks.

Sweeping tax exemptions were granted in order to make the farm loan bonds attractive to investors. Section 26 of the Act provides:

First mortgages executed to federal land banks, or to joint-stock land banks, and farm loan bonds issued under the provisions of this Act, shall be

[1] *Third Annual Report of the Federal Farm Loan Board*, 1919, p. 4.

deemed and held to be instrumentalities of the government of the United States, and as such they and the income derived therefrom shall be exempt from federal, state, municipal, and local taxation.

The capital, surplus, and dividends of federal land banks and farm loan associations are also exempt from federal, state, municipal, and local taxation except taxes on real estate owned. Shareholders in joint-stock land banks are taxable in the same manner as those in national banks. The justification for exemption from state and local taxation seems to have been that, since the land is already taxed, the taxation of a mortgage involves double taxation. It was assumed that exemption of the bonds from taxation would result in lower rates to borrowers. Lack of uniformity in state laws regarding the taxation of moneys and credits furnished a still further argument for exempting the bonds from state and local taxation if they were to be in fact "a standard form of investment."

CONDITIONS UNFAVORABLE TO A SUCCESSFUL START

The banks began their operations in March, 1917, just as our country entered the world-war. The first bonds, which were offered to the public almost immediately after the first Liberty Bond Campaign closed, bore interest of 4½ per cent and sold readily at a premium.[1] Subsequent issues of farm loan bonds were not so quickly absorbed, and in order to eliminate competition with the Liberty Bonds, an amendment to the Farm Loan Act was approved January 18, 1918, which authorized the Secretary of the Treasury to buy farm loan bonds to an amount not to exceed $100,000,000 in each of the fiscal years ending June 30, 1918, and June 30, 1919. It was further provided that the temporary organization of the federal land banks should be continued as long as any of the bonds so purchased were held in the Treasury.[2] The effect of the latter provision has been to place the entire control of the banks in the hands of directors appointed by the Federal Farm Loan Board. Under the authority to purchase bonds, the Treasury held on June 30, 1919, $135,888,000 of the bonds, although in the meantime

[1] Putnam, "The Federal Farm Loan System," *American Economic Review*, March, 1919, pp. 66, 67.

[2] *Amendments to the Federal Farm Loan Act*, Circular No. 11, Federal Farm Loan Board.

some had been repurchased by the land banks and sold to the public.[1] Farm loan bonds authorized to November 30, 1919, amounted to $286,100,000. Approximately half of them, therefore, were in the hands of the government.

The constitutionality of the tax-exemption feature of the law was naturally challenged, and, quite as naturally, the attack was made by interested parties. The suit was instigated by the farm mortgage bankers. The active campaign against the constitutionality of the law appears to have started at the 1917 convention of the Farm Mortgage Bankers Association of America. A subscription was taken and voluntary contributions were made by members of the association, as individuals, in order to carry on the fight.[2]

The suit to test the constitutionality of the Act was brought in August, 1919. While this litigation was pending it was impossible to sell bonds to the public and the authority of the secretary to buy bonds had expired. New loans were accepted for a time, but, when no decision had been reached early in February, 1920, the Farm Loan Board ordered future application for loans held in abeyance.[3] Those applications which had already been approved were closed as formerly. In order to raise funds temporarily the banks made loans, subject to call, with banks in various cities, giving farm mortgages as collateral security.[4] In May, 1920, Congress passed a resolution extending the provisions of the amendment of January, 1918, to the fiscal years 1920 and 1921. The secretary was allowed to use the unexpended balance of the

[1] *Annual Report of the Secretary of the Treasury*, 1919, pp. 136–39.

[2] *Proceedings of the Fourth Annual Convention of the Farm Mortgage Bankers Association of America*, 1917, pp. 70, 88–105, 147–58. The mortgage bankers through their national association have attacked the system at various other points. They have opposed the public subsidy which comes from making the Farm Loan Board a bureau of the Treasury Department; they have charged certain administrative defects such as making loans to men who are not actual farmers, loaning beyond the $10,000 maximum to one borrower, and making loans beyond 50 per cent of the value of the land. Their main attack, however, has centered upon the provisions of the law which exempt the securities of federal land banks and joint-stock land banks from all taxation.

[3] *Commercial and Financial Chronicle*, Vol. CX (Feb. 14, 1920), p. 612.

[4] *Federal Trade Information Service*, Vol. XV, No. 29 (May 4, 1920), p. 225.

$200,000,000 authorized by the former amendment for the purchase of bonds. About $64,000,000 was available for this purpose. No bonds could be purchased if issued against loans approved after March 1, 1920.[1] Loaning operations of the banks were, therefore, almost entirely suspended for a year. On November 30, 1918, the aggregate loans of the twelve federal land banks were $147,000,000; on the same date in 1919, they were $282,000,000; by May 31, 1920, they amounted to $333,000,000; and by December 31, 1920, they had increased only to $346,000,000.[2]

HISTORY AND ISSUES OF THE SUIT

The suit was delayed for some time after the preliminary action had been taken, partly because it was difficult to determine how to bring the case into the federal courts so that all the issues could be covered in a single petition. Finally an action was brought in August, 1919, by a stockholder of the Kansas City Title and Trust Company enjoining the officers of the company from investing any funds of the stockholders in bonds issued under authority of the Federal Farm Loan Act. The First Joint Stock Land Bank of Chicago and the Federal Land Bank of Wichita, Kansas, were allowed to intervene, and became parties defendant to the suit.[3] The case was heard October 30, 1919, in the District Court of the United States for the Western District of Missouri. The argument of the case occupied only two days, at the end of which time the court dismissed the bill. Appeal was immediately taken,[4] and the case was argued before the Supreme Court January 6, 7, and 8, 1920. On April 26, 1920, the court ordered the case reargued. Since oral arguments for that term of court closed April 30, the case had to go over to the October term.[5] The decision of the

[1] *Amendments to the Federal Farm Loan Act*, Circular No. 11, Federal Farm Loan Board.

[2] *Annual Reports of the Federal Farm Loan Board*, 1919, p. 21; *Report of the Federal Farm Loan Board*, 1920, p. 3; Federal Farm Loan Bureau mimeographed sheet No. 545.

[3] *Smith* vs. *Kansas City Title and Trust Company, et al.* 41 Supreme Court Reporter, 243–50.

[4] *Third Annual Report of the Federal Farm Loan Board*, 1919, p. 19.

[5] *The Commercial and Financial Chronicle*, Vol. CX (May 8, 1920), p. 1931.

court was announced February 28, 1921, Justice Day delivering the opinion.[1]

The suit, as brought, involved the constitutionality of the entire Act, although the counsel for the appellant stated in reargument that "the tax exemption is the real issue sought to be settled here."[2] The contention that the Act was unconstitutional was based upon three points: first, Congress has no power to create a corporation for the purpose of conducting a farm-mortgage loan business or to exempt it from state control; second, the mere expedient of calling such corporations "banks" and endowing them with the possibility of acting as depositories of public money or as financial agents does not give Congress this power; third, the farm loan bonds are subject to state taxation.[3]

The first point pertained solely to the federal land banks. Judge Charles E. Hughes, on behalf of the federal land banks, argued that Congress had power to appropriate public money for the purpose of stimulating agricultural development, holding that "the purposes in view were public, not private; national, not local."[4] It was shown that at the outset practically all of the capital of the land banks was actually supplied by the United States Treasury, and that the Secretary of the Treasury, under the amendment of January 18, 1918, had purchased and held $175,000,000 of the bonds. The opposition pointed out that the government's capital subscription was accidental and temporary.[5] Moreover it was contended that it had never been suggested that the creation of the First and Second Banks of the United States could be sustained under the power of appropriation, although

[1] *Smith* vs. *Kansas City Title and Trust Company, et al.* 41 Supreme Court Reporter, 243–50. Justice Brandeis took no part in the consideration or decision of the case because he was an owner of farm loan bonds. Justices Holmes and McReynolds expressed no judgment on the merits of the case because they held that the court had no jurisdiction in the case.

[2] "Brief for Appellant on Reargument," p. 5.

[3] *Ibid.*, pp. 12, 13.

[4] "Supplemental Brief for Appellee," Federal Land Bank of Wichita, Kansas, on reargument, pp. 23–67.

[5] The government provided $8,892,130 of the initial capital but under the terms of the Act this had been reduced to $6,832,680 on December 31, 1920. The Act contemplates that it will all be retired eventually.

in both cases the government's subscription was permanent. In the opinion of the court the question of the ownership of the banks could not be considered as the deciding factor. The power of Congress to establish banks for national purposes, even where the majority ownership is private, however, had been clearly established in *McCulloch* vs. *Maryland* and *Osborn* vs. *Bank*.[1] Upon the authority of these cases the court had later rested the constitutionality of the legislation establishing the national banks.

On the second point at issue it was argued that the power to designate these banks as depositories had not been exercised by the government, and that the federal land banks had acted as fiscal agents only in the case of loans for seed purposes.[2] It was contended, therefore, that these powers were merely incidental and not essential in any way to the farm mortgage business. The charge that these powers had been conferred on the two classes of banks merely as a pretext was entirely brushed aside by the court. The court emphatically stated that it is not within the province of the judicial branch of the government to question the motives of Congress as long as the latter acts within the limits of its constitutional authority. Congress had seen fit to make both classes of banks depositories of public money, when so designated by the Secretary of the Treasury, and had authorized their use as fiscal agents of the government. It was pointed out that in the decisions supporting the constitutionality of the Second Bank of the United

[1] *McCulloch* vs. *Maryland* (4 Wheaton 316) decided the constitutionality of the act of Congress chartering the Second Bank of the United States. The opinion, written by Chief Justice Marshall, was one of a long line of decisions through which he elaborated the fundamental powers of the federal government.

Osborn vs. *Bank* (9 Wheaton 738) involved the validity of an Ohio law passed "for the avowed purpose of expelling the Bank (Second Bank of the United States), from the State," and imposing an annual tax of $50,000 on each of the two branches, for the privilege of doing business in Ohio. In this case the constitutionality of the bank was again explicitly upheld.

[2] The Federal Land Banks of Wichita, Spokane, and St. Paul were designated fiscal agents for the purpose of making loans to farmers in certain drought-stricken areas for the purchase of seed grains during the summer of 1918. These loans were made from the President's war emergency fund. About 15,000 loans were made, aggregating over $4,500,000. The loans were secured by crop liens. This service was rendered by the banks without any compensation except for the actual expenses involved. See *Third Annual Report of the Federal Farm Loan Board*, 1919, pp. 18, 19.

States, Chief Justice Marshall had given as a principal consideration the fact that the formation of the bank was required, in the judgment of Congress, for the fiscal operations of the government.

Other privileges and duties granted to the farm loan institutions in no way detracted from the authority of Congress to use them for the governmental purposes named, and hence could not destroy the validity of the law. Whether these institutions could be technically called banks or not, the court did not undertake to decide, but gave a broad interpretation of banking in these words: "Speaking generally, a bank is a moneyed institution to facilitate the borrowing, lending, and caring for money." The action of the court in sustaining the power of Congress to authorize national banks to act in a fiduciary capacity was cited to show that it was within the authority of Congress to permit banks to transact business, which, considered alone, might be beyond the power of Congress to authorize.[1] Resting on these earlier cases, the court concluded that it was lawful for Congress to create the banks even where they were intended primarily to facilitate the making of farm loans.

The chief contention was made upon the third point at issue—that the farm loan bonds are subject to state taxation. The farm mortgage bankers had especially hoped to have the sections pertaining to tax exemption adjudged unconstitutional. Section 34 of the Act specifically limits court decisions by stating that if any clause or section of the Act should be held invalid, such judgment would not affect or impair the remainder of the Act but would be confined to the part directly involved. The court concluded, however, that, since it had been decided that the power to create these institutions was within the legitimate scope of the authority of Congress, the power to make the securities tax-exempt necessarily followed. This principle was held to have been settled in the cases of *McCulloch* vs. *Maryland* and *Osborn* vs. *Bank*. Quoting Chief Justice Marshall in the former case, the court said:

> That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; there is a plain

[1] The Federal Reserve Act permits national banks (Sec. 11 K) to act in a fiduciary capacity. The validity of this was upheld in *First National Bank* vs. *Union Trust Company* (244 U.S. 416) decided June, 1917.

repugnance, in conferring on one government a power to control the constitutional measures of another, which other, with respect to those very measures, is declared to be supreme over that which exercises the control, are propositions not to be denied.

The court pointed out that the same principle had been further recognized in the *National Bank Cases* by limiting the state taxation of the property and franchises of national banks to the amount authorized by the laws of Congress.

OPERATIONS OF THE FARM LOAN SYSTEM

Before considering possible changes in the law, it is desirable to examine the results of the operations of the system to date to see how well it has fulfilled the general purposes of its founders.

In spite of disturbed financial conditions and court litigation the banks have succeeded in making a large volume of loans. The mortgage loans of the twelve federal land banks at the close of business, December 31, 1920, aggregated $349,678,987. Upon the same date the net mortgage loans of the joint-stock land banks were $77,958,642.[1] Capital to the extent of over $425,000,000 therefore, had been supplied to aid in agricultural development.

During the past two years the federal land banks have established themselves on a firm financial basis. The net earnings to December 31, 1920, were $4,504,820. Dividends of $1,533,104 had been paid and a total surplus and undivided profits of $2,861,236 had been accumulated.[2]

It was expected that the federal farm loan system would lower and equalize interest rates on farm loans. The disturbing effects of the war make it difficult to determine just how much influence it has had. In the favored corn-belt territory private companies have been able to compete effectively. On $61,152,392 of new loans granted by life insurance companies in Iowa during the first nine months of 1917, the interest rate was 5.18 per cent.[3] This was while the federal land banks were being organized and before their influence was felt. At the outset the mortgage rate

[1] *Annual Report of the Federal Farm Loan Board*, 1920, pp. 3, 4.

[2] *Ibid.*, p. 4.

[3] Wight, *Life Insurance Farm Loan Investment in War Time*, p. 11.

of the federal land banks was 5 per cent. The rate was subsequently raised to $5\frac{1}{2}$ per cent and, with the renewal of loaning activities this spring, to 6 per cent. The aggregate loans of the federal land bank and the eight joint-stock land banks in Iowa on May 31, 1920, were $46,956,445, which is the largest total for a single state.[1] This large volume of loans can hardly be ascribed, however, to marked reductions in interest rates.

The situation seems to have been quite different in other states. In Wyoming, also in the eighth district, new loans of $29,400 were made by the insurance companies during the period January 1–September 30, 1917. The rate on these loans was 7.43 per cent.[2] Insurance companies scrutinize their loans very carefully and accept only the best. It is safe to assume, therefore, that most of these loans would have been acceptable under the Federal Farm Loan Act. Borrowers in that state have apparently been able to effect a saving of about 2 per cent per annum.

To bring the general interest rate for all mortgages below that now prevalent in Iowa and Illinois will be a difficult task. The system has, however, done something toward making interest rates more uniform over the entire United States. Doubtless such wide variations as formerly existed were unwarranted, but the effort to bring the Iowa and Wyoming borrowers to the same level appears to be contrary to economic principles.

One immediate effect of the Supreme Court decision was to protect the interests of all of the present bondholders. Whatever change Congress may see fit to make in the law will not alter the status of the outstanding bonds. In the second place, the banks are now free to resume activities. In renewing loaning operations, the banks have proceeded somewhat slowly. The Farm Loan Board has asked the banks to refuse to make loans when the funds are desired for the purpose of paying existing debts that are not yet due. This ruling was made because it was assumed that it would be difficult to sell a sufficient amount of bonds to enable the banks to meet all demands for loans. By limiting the loans in

[1] Mimeographed sheets issued by Federal Farm Loan Bureau, Nos. 548 and 555.

[2] Wight, *op. cit.*

this way it was expected that the banks could take care of the most pressing needs of the farmers.

THE POLICY OF TAX EXEMPTION

The farm mortgage bankers directed a great deal of fire throughout their campaign upon the exemption from the federal income tax, but this point could not be raised directly in the suit. The contention was made that the bonds are subject to state taxation. The effect of the decision, therefore, was to settle the legality of exemption from state taxation. At this point the law, in the author's opinion, represents correct policy. The preamble to the Act states that, among other things, the purpose was to create "a standard form of investment." Since the Act was passed the enormous issues of Liberty Bonds have supplied the present generation with a large quantity of "standard investments." Nevertheless, it seems desirable to place the bonds on such a basis that they will have the widest possible market. This they cannot have if subject to the varying tax provisions of forty-eight different commonwealths.

The diversity of tax rates has been forced upon the writers' attention by his personal experience in the past five years, during which time he has resided in four different states. Three of these furnish a typical example. In Iowa a \$1,000 bond or mortgage would be taxed at the uniform rate of \$5.00, regardless of the local tax rate on general property; in Ohio the same bond or mortgage would have been taxed \$21.60; in Washington it would be entirely exempt. Reduced to an income-tax basis upon 6 per cent securities, this represents rates of $8\frac{1}{3}$ per cent, 36 per cent, and 0 respectively. Under such conditions a bond or mortgage could scarcely be regarded as a standard investment.

As a matter of fact, it is probably true that at the present time a relatively small proportion of farm mortgages are actually paying taxes to state and local governments. This comes about, in the first place, because many mortgages are owned by institutions not subject to the general property taxes. Mr. Guy Huston, president of the First Joint Stock Land Bank of Chicago,

estimates the distribution of ownership of farm mortgages in the United States as follows:[1]

Insurance companies	$1,100,000,000
Savings and commercial banks	1,000,000,000
Eleemosynary institutions	400,000,000
Local loans	1,250,000,000
All others	250,000,000
Total	$4,000,000,000

In most states the securities of insurance companies and banks are not subject to the general property taxes, but are covered by special forms of taxation on earnings or capital. Eleemosynary institutions are tax exempt. In some states, as Washington, the others are granted full exemption. Only a small proportion of the mortgages subject to state taxation are actually taxed. They. are placed beyond the reach of the tax-gatherer by the familiar devices of purchasing mortgages made and recorded in the name of a bank or mortgage company, holding mortgages executed in other states, or simply refusing to declare them to the assessor. Mr. Huston estimates that less than 5 per cent of the farm mortgages in the United States are actually taxed.[2]

The policy of exempting the bonds from federal taxes is an entirely different question.

Although the Supreme Court settled the legal right of Congress to make the bonds tax exempt, was it not within its jurisdiction to make any decision upon the wisdom of the measure. In fact, the court especially emphasized its own position in this respect by stating:

> With the wisdom and policy of this legislation we have nothing to do. Ours is only the function of ascertaining whether Congress in the creation of the banks and in exempting these securities from taxation, federal and state, has acted within the limits of its constitutional authority.

[1] *Hearings before the Committee on Banking and Currency*, United States Senate Sixty-sixth Congress, Second Session on S. 3109, p. 61. It is not possible to get more accurate statistics. Huston's estimate of life insurance investments, at least, checks fairly well with official reports. On December 31, 1916, 159 of the largest companies reported farm loans aggregating $828,568,867. The enormous increase in the insurance business in the past four years would seem to warrant Mr. Huston's estimate so far as they are concerned. See Wight, *op. cit.*

[2] *Working Capital for the American Farmer*, addressed to Minnesota Farm Mortgage Bankers Association, Jan. 27, 1921, p. 17.

President K. N. Robins of the Farm Mortgage Bankers Association has said: "The decision settled the law but not the economics or public policy."[1] Evidently the Association expects to carry the fight to the floor of Congress with the hope of securing amendments in the law. Nor will they be alone in asking for changes, for there is a growing public sentiment against tax exemption of all kinds. Revolutionary changes have taken place in our taxation system since the Federal Farm Loan Act was passed in 1916. The income-tax law was then new and its rates were low. Government bonds had commonly been granted exemption from all taxes—federal and state. It had been a generally accepted principle that exemption of bonds from taxation directly benefited the borrower.

Whatever may have been the fact as to the beneficiary of tax exemption before the federal income-tax law was passed, there cannot be any doubt that under present conditions tax exemption is a boon to men with swollen incomes. So far as the federal income tax is concerned, any 6 per cent bond will yield its full 6 per cent to an investor whose income is not above the $2,000 minimum allowed a married man without children. To a man with an income of $10,000 the net yield would be about 5.4 per cent. But on a million-dollar income the net return, after paying the income tax, is only 2 per cent. On the other hand, the largest income may entirely escape taxation by conversion into tax-exempt securities. The possessors of large incomes seem to be fully awake to this possibility. In his annual report for 1920, Secretary Houston says:[2]

> For the year 1916, net income amounting to $992,972,985 was included in the returns of taxpayers having net incomes over $300,000 a year. This aggregate fell to $731,372,153 for the year 1917 and to $392,247,329 for the year 1918. There is little reason to believe that the actual income of the richer taxpayers of the country had fallen in that interval. It is the taxable income which has been reduced and almost certainly through investment by the richer taxpayers in the tax-exempt properties.

Very few of these investors shifted to farm loan bonds, for the total authorized for both classes of banks to November 30, 1919,

[1] *Special Bulletin No. 75, Farm Mortgage Bankers Association of America.*

[2] "Annual Report of the Secretary of the Treasury" (1920), pp. 36, 37, as quoted in *Special Bulletin No. 72 of the Farm Mortgage Bankers Association.*

was $342,235,000 and about half of these had been bought by the Secretary of the Treasury.[1] There are no reliable statistics of the total of tax-free securities now outstanding, but the amount is known to be very large. The federal bureau of the census placed the total state indebtedness at $422,000,000 and that of the counties, municipalities, and other civil divisions at $3,475,000,000 in 1913, an aggregate of about four billion.[2] Securities of this class have always enjoyed tax exemption under the reciprocal relationship that has existed between the different divisions of government. Since 1913 this amount has largely increased and, moreover, there are other classes of tax-free securities. W. W. Powell, secretary of the American Association of joint-stock land banks, has placed the total at $17,000,000.[3]

In any case, the volume of tax-exempt securities is very large. Investors not subject to the super-rates of the income tax can receive higher returns by selecting the 4¼ or 4¾ per cent Liberty Bonds or industrial issues, leaving to the very wealthy a free field in the low-rate, tax-free liberty, state, and municipal bonds. The gain to the public treasuries in lower interest rates is, therefore, not equal at all to the saving to the rich taxpayer. The result is virtually to defeat the purpose of the graduated income-tax law.

This condition is attracting the serious attention of students of taxation. Professor Carl C. Plehn has summarized the situation as follows:[4]

> A much discussed question in the United States is whether public bonds should be taxable or not. The matter is really very simple. But the public

[1] *Third Annual Report of the Federal Farm Loan Board*, 1919, pp. 28, 29.

[2] *Abstract of Special Bulletins, Wealth, Debt, and Taxation*, 1913, pp. 20, 21.

[3] His estimates follow:

Municipal, county, and state bonds	$7,000,000,000
Special assessment bonds of cities	1,000,000,000
Mutual Savings Bank securities	3,000,000,000
Building and loan securities	1,700,000,000
First and last Liberty Bonds	4,000,000,000
Federal Reserve bank stock	87,000,000
Farm loan bonds	300,000,000

See *Hearings before the Committee on Banking and Currency on S. 1309*, January 10, 12, and 13, 1920.

[4] Plehn's *Introduction to Public Finance* (4th ed.), pp. 362–63.

mind is greatly confused and scarcely knows what the issue is. What happened was as follows: As long as the general property tax was the only tax likely to fall upon a public bond, the interest rate paid by the government would have to be equal to the market rate of interest plus (1) the property tax, and (2) the cost of shifting the tax. This was so because the holder of a public bond feared that it would surely be discovered and taxed. But he knew of many other places where he could put his money and receive the market rate of interest, without a tax to pay. So if a state government issued a taxable bond it paid out in extra interest more than it could hope to get back in taxes. Moreover, it *might* not get the taxes back and yet have to pay the higher rate of interest. It was not even as broad as it was long, for the government was sure to save the cost of shifting if it issued tax-free bonds, and to pay only the market rate of interest. So it naturally came about that public bonds were sold tax free. But the matter took on a very different complexion when the income tax came in. Not having foreseen the income tax, the covenant had customarily read "free of all taxes," which was understood to cover an income tax on the interest. Now if the income tax were a property tax the situation would be much the same as it was when the general property tax was the only one to consider, and the sensible thing to do would be to continue the old exemption plan. But the income tax is a personal tax, so the situation is quite different. Interest on public bonds is funded income, and instead of exempting it the logic of the tax requires that it be taxed more heavily even than earned or unfunded income. The matter is still further complicated by the surtax, especially by the very high surtaxes; for tax-free bonds constitute a fund for investments by very rich persons where their income is free of the surtaxes. The whole matter could be settled by providing that the exemption applies only to property taxes and that the interest when it merges in a private income loses its identity as interest. While the amount of tax exemption won in this way has been undoubtedly grossly exaggerated and the contracts issued in the past must be respected, there is no good reason for perpetuating the error in future issues.

Secretary Glass has stated his opinion as follows:[1]

It is intolerable that taxpayers should be allowed, by purchase of exempt securities, not only to obtain exemption with respect to the income derived therefrom, but to reduce the supertaxes upon their other income, and to have the supertaxes upon their other income determined upon the assumption, contrary to fact, that they are not in possession of income derived from state and municipal bonds. . . . . The very great advantage the states and municipalities now have in conferring upon holders of their bonds larger exemptions from federal taxation than the federal government itself confers upon the holders of Liberty Bonds should be reduced as far as it may be reduced by the adoption of appropriate administration provision in the Federal Revenue Law.

[1] *Annual Report of the Secretary of the Treasury*, 1919, pp. 24, 25.

NEEDED CHANGES IN THE LAW

The central issue in the fight against the constitutionality of the law as it stands was the tax exemption. Granting that the principle of tax exemption is, broadly speaking, unsound, there is a constitutional difficulty involved in bringing the income from municipal, county, and state bonds under the federal Income-Tax Law.[1] Municipal bonds are the chief potential competitors in the market with the farm loan bonds, and the fact that the former remain exempt has been held to justify complete exemption of the farm loan bonds also. The contention does not, however, seem to be sound. In the first place, municipal bonds are not entirely tax exempt but are subject to state and local taxation in a number of the states.[2] Again, the present situation of farm loan bonds enjoying tax exemption superior to Liberty Bonds is an anomalous one and sets a bad precedent which will lead to demands for further exemptions of a similar nature. There has already been proposed a system of home loan banks on the same basis. Finally, in this matter, Congress has full power to act, whereas the municipal bonds are apparently beyond its jurisdiction.

A law should be passed placing the future issues of farm loan bonds on the same basis as the $4\frac{1}{4}$ and $4\frac{3}{4}$ per cent Liberty Bonds. In taking such action Congress would simply repeat what was done in the matter of Liberty Bonds. The first issue of $3\frac{1}{2}$ and the $3\frac{3}{4}$ per cent Victory Notes of the Fifth Loan were made exempt from all income taxation; other issues are exempt only from the normal income tax. Even this partial exemption may be questioned, and the only reason for suggesting it in the case of farm loan bonds is the precedent in the national bonds.

[1] In passing the Income Tax Law of 1919, Congress refused to treat as within its taxing powers, interest received from bonds issued either by a state or any of its counties or municipalities (*Congressional Record*, LVII, 553, 774–77, and 2988). Congressman McFadden has proposed an amendment to the federal Constitution which would legalize an income tax on future municipal securities. It is beyond the scope of this paper to discuss the merits of this proposal, but it has received serious consideration in many quarters, and there appears to be a growing sentiment in its favor.

[2] In the following states, at least, taxation on the municipal bonds of other states is rigidly enforced: California, Illinois, Massachusetts, New York, Ohio, Pennsylvania, and Wisconsin.

If Congress should choose the course here outlined of subjecting the farm loan bonds to the federal income tax but continuing the exemption from state taxation, would the taxed bonds sell? If they bear interest of only 5 per cent, the answer would seem to be that they could not be sold at par under present conditions in the bond market. During the latter part of April a new issue of forty million of federal land bank bonds, dated May 1, 1921, was offered to the public. These bonds are ten-twenty-year bonds; that is, they are not redeemable before May 1, 1931, and are due May 1, 1941. They bear interest at 5 per cent and range in denominations from $40 to $10,000.[1] The bonds are being offered at par, and until the results of this issue are definitely known it will be impossible to tell how such bonds will sell.[2] Under present conditions they will appeal chiefly to investors having large incomes. They are on about the same basis as the $3\frac{1}{2}$ per cent Liberty Bonds which are selling at prices to yield slightly less than 5 per cent. Subject only to the normal income tax, the $4\frac{1}{4}$ or $4\frac{3}{4}$ Liberty Bonds are a more attractive investment. The Fourth $4\frac{1}{4}$ Bonds, due in 1938, and not callable until 1933, compare most nearly as to maturity with this issue of land bank bonds, and these can now be bought to yield the purchaser about $5\frac{1}{2}$ per cent. This would seem to furnish a fair basis for estimating what interest rate would be necessary to render the farm loan bonds salable at par, if they were subject to the same tax provisions.[3] If anything, the Liberty Bonds would sell more readily, for they are more widely known and are supposed at least to be more secure.

But the probability that these bonds could not be sold on a 5 per cent basis does not constitute a sufficient argument against the proposal. Industrial enterprises, railroads, and other essential businesses are forced to sell their bonds on a much higher interest

[1] By an amendment approved April 20, 1920, the minimum denomination of farm loan bonds was raised to $40 and the former maximum of $1,000 was stricken out. *Public Document No. 182*, Sixty-sixth Congress (H.R., 9065).

[2] Early reports from local bankers and bond dealers indicate a very slow sale.

[3] Prior issues of farm loan bonds are redeemable five years from date of issue and hence cannot be used as a basis for determining the value of the new series. This is the first issue of farm loan bonds to begin redemption in the eleventh year from date of issue.

basis. The federal Treasury has paid as high as 6 per cent on recent issues of Treasury certificates of indebtedness. If partially taxed bonds could be sold on a $5\frac{1}{2}$ per cent basis, loans could still be made to farmers at reasonable rates. The banks have normally operated on a 1 per cent margin, the farm mortgage rate at present being 6 per cent. Some loans have been made with a $\frac{1}{2}$ per cent spread, but presumably this is not regarded as sufficient for operating expenses. Under the co-operative plan of the federal land banks it is expected that the borrowing farmers will receive back in dividends any saving made in operating costs. If some loans are made on a 1 per cent margin and others on a $\frac{1}{2}$ per cent, the profits are pooled, a procedure which is unjust to those whose loans are on the wider margin. It seems desirable, therefore, that the margin should be uniformly 1 per cent. All borrowers will then secure their loans on the basis of interest rates prevailing when their loans are made. To raise the mortgage rate above 6 per cent would necessitate an amendment to the Act. However, the change in interest rates that has taken place during the past five years would seem to justify this action. Borrowers at the present high rates could take advantage of the privilege of paying their loans after the mortgage had run five years and could renew at the prevailing rate.

In the discussion we have proceeded throughout as if both classes of banks operating under the Act were to be treated alike. As a matter of fact there is a strong probability that the first legislative action will be directed against the joint-stock land banks. A bill to repeal their tax-exemption privileges was before the last Congress.[1] On April 12, 1921, Senator Smoot introduced a bill in the Senate which, if passed, would completely eliminate the joint-stock land banks.[2]

In his annual report for 1920, Secretary Houston recommended the removal of the tax-exemption privilege on the ground that joint-stock land banks are private institutions organized for profit.[3]

[1] S. 3109, Sixty-sixth Congress, Second Session.

[2] S. 431, Sixty-seventh Congress, First Session.

[3] "Annual Report of the Secretary of the Treasury" (1920), pp. 188, 189, as quoted in *Special Bulletin No. 72, Farm Mortgage Bankers Association of America.*

His recommendations seem to include all tax exemptions, federal and state. He accompanies this with a caution that provision must be made to safeguard the interests of existing joint-stock land banks. Without making a specific recommendation upon the point, he suggests further that if this is done the federal land banks might be authorized by Congress to extend their loaning power to cover the classes of loans which joint-stock land banks are now permitted to negotiate.

The wisdom of providing a dual system of farm loan banks has been seriously questioned and the experiment cannot yet be said to have had a full trial. Only nine joint-stock land banks were in operation before 1919. During that year the number increased to thirty and their loans from \$7,289,870 to \$54,126,357. They were practically inactive from March, 1920 to March, 1921, and three of them went into voluntary liquidation. The loans outstanding December 31, 1920, amounted to \$77,958,642.[1]

Joint-stock land banks have gone into the cream of the territory serving borrowers already quite well taken care of by mortgage companies. Out of a total of \$80,887,871 loans closed by the thirty joint-stock land banks to May 31, 1920, \$23,924,095 were in Iowa and a large percentage of the remainder were in the neighboring corn-belt states. Interest rates in these states were already low and terms liberal.[2] On the other hand, there are not joint-stock land banks operating in several of the western states where only a limited amount of private capital has been available and that at high rates. The joint-stock land banks are not restricted by law as to the amount of an individual loan, or the purposes for which the money may be loaned, nor to making loans only to actual farmers. Under its general powers of supervision the Board has limited the maximum loan to \$50,000 and restricted the purposes for which loans may be made. It still remains true, however, that the banks may make large loans and may lend money to landlords and speculators.

Either Congress should make the purposes identical for both classes of banks and impose some limitation upon the eligibility of

[1] *Report of the Federal Farm Loan Board,* 1920, pp. 2, 4.

[2] The life insurance companies held \$195,782,521 of Iowa farm mortgage loans on December 31, 1916, at an average interest rate of 5.28 per cent. Wight, *op. cit.*

borrowers, or else a discrimination in tax exemption against joint-stock banks is clearly warranted. On the other hand, if the joint-stock land banks are to be treated as private mortgage companies the law should be amended to allow them more liberal loaning opportunities. The maximum interest rate should be raised; the territory in which they may operate should not be restricted as at present to two states; provision should be made for retaining the old constituency of borrowers by allowing them to make straight term mortgages as well as amortized loans;[1] the lending power should be raised from fifteen to twenty times the capital and surplus.

The question of the future of the joint-stock land banks should be settled as early as possible. At present there are less than thirty such banks, with a relatively limited volume of loans. There is little doubt that the present number will increase and the volume of loans of the existing banks will expand, now that the constitutionality of the law has been sustained.[2] Before this takes place their status should be clearly established.

A further change which should be made in the law as it now stands is to require the federal land banks and joint-stock banks to assume the expenses of the Farm Loan Board. This would place the system on a self-supporting basis, following the precedent of the Federal Reserve System. The Board looks with favor upon such a course and has recommended it to Congress. A bill to that effect passed the Senate during the second session of the last Congress and has recently been reintroduced by Senator Smoot for consideration in the special session.[3] This change will doubtless soon be made.

[1] The first joint-stock land bank to be organized, the Iowa Joint Stock Land Bank of Sioux City, is controlled by the same interests that operate the Farmers Loan and Trust Company of Sioux City. In this way, borrowers are given their choice of making loans on either basis. The Farm Loan Board has ruled that this is permissible. A number of other banks have been organized on the same basis. See *Proceedings of the Fourth Annual Convention of the Farm Mortgage Bankers Association of America*, 1917, p. 63.

[2] Speaking before the Iowa Farm Mortgage Association in 1918, F. W. Thompson advised the farm mortgage men to "get in with both feet as fast as you can" if the Supreme Court sustains the constitutionality of the Act.

[3] *Congressional Record*, April 12, 1921, p. 73, S. 432.

The purchase of farm loan bonds by the Treasury has been criticized on the ground that it also represents a government subsidy to landowners. The justification for the action can be found in the war emergency. New loans were needed by farmers and the federal land banks could not function without selling their bonds. Bonds could not be sold readily in the face of Liberty Loan campaigns. For the most part they bear interest at a higher rate than the government was paying for money when the bonds were bought, but the Treasury has since paid as high as 6 per cent on treasury certificates of indebtedness. Holding these bonds, therefore, represents a net loss to the government. As soon as it is feasible the federal land banks should redeem them, but since many of them bear only $4\frac{1}{2}$ per cent interest it will be difficult to dispose of them on the present market. The amendment of 1918 provided that as long as the Treasury holds any of these bonds, the temporary organization of the banks should be continued. This condition should be terminated as soon as possible.

Certain administrative blunders have been charged against the federal land banks in the course of the campaign against the system. It has been held in the first place that loans have been made to landowners who are not actual farmers. Pictures have been circulated showing the city residences of some of the Iowa borrowers. It would appear that in some cases the banks have been rather lenient in interpretation of what constitutes an actual farmer. It seems that where the arrangement between landowner and farm-operator could be construed as a partnership contract, the loan has been allowed. Straight share leases have been ruled out, however, and, on the whole, the number of cases where the spirit of the Act has been overstepped at this point is relatively small.

Again it has been shown that in certain cases the provisions for a maximum loan of $10,000 have been evaded by deeding a portion of the farm to other members of the family temporarily. The evidence in certain cases is undisputed, but again the number of such occurrences has apparently not been large. In Iowa and the adjoining states the high value of land renders the $10,000 maximum burdensome. On behalf of the farmers in that territory an effort has been made to increase the loan limit from $10,000 to $25,000.

This amendment would be justified if the tax-exemption section is also amended.

CONCLUSION

It may be concluded that the banks are firmly established and that they are being managed well. Administrative irregularities have doubtless occurred and the Board itself recognizes the need for certain changes, notably more frequent examinations of the national farm loan associations. In the matter of tax exemption, the Act granted more liberal conditions than are warranted. The legality having been established, Congress now has a free hand to amend Section 26 along the lines of sound public policy. Hasty action is unnecessary and would be unwise, but serious consideration should be given to the matter. The position of the joint-stock land banks should receive the earliest consideration so as to settle clearly their status while their number is still small.

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